No. 12391

In the United States Court of Appeals for the Ninth Circuit

AGNES M. KANNE, EXECUTRIX UNDER THE WILL AND OF THE ESTATE OF FRED H. KANNE, COLLECTOR OF INTERNAL REVENUE OF THE UNITED STATES FOR THE DISTRICT OF HAWAII, APPELLANT

v.

AMERICAN FACTORS, LIMITED, AN HAWAIIAN CORPORATION, APPELLEE

AMERICAN FACTORS, LIMITED, AN HAWAIIAN CORPORATION, APPELLANT

v.

AGNES M. KANNE, EXECUTRIX UNDER THE WILL AND OF THE ESTATE OF FRED H. KANNE, COLLECTOR OF INTERNAL REVENUE OF THE UNITED STATES FOR THE DISTRICT OF HAWAII, APPELLEE

ON APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF HAWAII

REPLY BRIEF FOR AGNES M. KANNE

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,
LELAND T. ATHERTON,
Special Assistants to the Attorney General.

RAY J. O'BRIEN,
United States Attorney.

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Agnes M. Kanne, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, appellant

v.

American Factors, Limited, an Hawaiian Corporation, appellee

American Factors, Limited, an Hawaiian Corporation, appellant

v.

Agnes M. Kanne, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, appellee

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ON APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF HAWAII

REPLY BRIEF FOR AGNES M. KANNE

I

A. Taxpayer's counsel are mistaken in their assertion that the argument of counsel for Agnes M. Kanne in regard to the deductibility of the Hackfeld litiga-

tion expense is based on the erroneous assumption that the costs of litigation were apportioned or prorated between the taxpayer on the one hand and the co-defendants on the other hand. (Answering Br. 6.)

We did indeed refer to the sum of $171,795.26 as the taxpayer's share of these expenses, but our identification of that portion of the expenses as the taxpayer's share was not based on any rash or erroneous assumption. It was based on the undisputed fact that the taxpayer paid that much of the total litigation expenses out of its own funds and did not ask or expect to be reimbursed therefor by its co-defendants. (R. 77-79, 198.) The $396,812.50 which the taxpayer refunded to its co-defendants in 1932 represented that portion of the total litigation expenses which the taxpayer's co-defendants offered to pay and did pay to the extent of the assessments against them and was contributed by them in 1924, 1925, and 1926 and was paid in years prior to 1932. (R. 78-79, 198-201.)

Thus, we are at a loss to understand the assertion by taxpayer's counsel, particularly in view of their later declaration that the taxpayer, acting as banker for the committee, paid bills approved by it, and, when a certain amount of expenses *had been incurred,* an assessment would be levied, divided by the number of shares, and collections would be made from each of the co-defendants on a per share assessment basis. (Answering Br. 7-9.)

It makes no difference that there was no prior agreement between the taxpayer and its co-defendants to prorate the litigation expenses between the taxpayer and its co-defendants. Notwithstanding the absence of such an agreement, the evidence indisputably shows that the expenses were actually apportioned between all the defendants and that the taxpayer received from

its co-defendants on account of the assessments made against them a total of $396,812.50. (R. 256-257, 291; Answering Br. 7-8.) Counsel's arguments to the contrary are specious and tend to confuse the real factual situation.

Viewing counsel's arguments objectively, it seems their purpose is to convey to this Court (we think erroneously) that without a prior agreement for the apportionment of these expenses between the taxpayer on the one hand and its co-defendants on the other hand, it could not be determined whether the taxpayer and/or its co-defendants were liable for these expenses until after the Hackfeld litigation was concluded in 1932. But liability for the expenses was incurred prior to 1932, and that liability was discharged in 1924, 1925-1926, 1927, 1928, 1929, and 1931. (R. 198-200.) It will be noted from the excerpt quoted below from the Court of Claims opinion in *Chestnut Securities Co. v. United States*, 62 F. Supp. 575, that it is unimportant that this liability may not have arisen as the result of a debtor-creditor relationship. The Court of Claims in the *Chestnut Securities Co.* case said (p. 576):

> One is not entitled to accrue a debt *or other liability* which is asserted against him but which he disputes and litigates, until the litigation is concluded. But if a liability is asserted against him and he pays it, though under protest, and though he promptly begins litigation to get the money back, the status of the liability is that it has been discharged by payment. It is hardly conceivable that a liability asserted against him, which he has discharged by payment, has not yet "accrued" within the meaning of the tax laws and the terminology of accounting. Accrual, from the debtor's standpoint, precedes payment, and does not survive it. (Emphasis supplied.)

tion expense is based on the erroneous assumption that the costs of litigation were apportioned or prorated between the taxpayer on the one hand and the co-defendants on the other hand. (Answering Br. 6.)

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Viewing counsel's arguments objectively, it seems their purpose is to convey to this Court (we think erroneously) that without a prior agreement for the apportionment of these expenses between the taxpayer on the one hand and its co-defendants on the other hand, it could not be determined whether the taxpayer and/or its co-defendants were liable for these expenses until after the Hackfeld litigation was concluded in 1932. But liability for the expenses was incurred prior to 1932, and that liability was discharged in 1924, 1925-1926, 1927, 1928, 1929, and 1931. (R. 198-200.) It will be noted from the excerpt quoted below from the Court of Claims opinion in *Chestnut Securities Co.* v. *United States,* 62 F. Supp. 575, that it is unimportant that this liability may not have arisen as the result of a debtor-creditor relationship. The Court of Claims in the *Chestnut Securities Co.* case said (p. 576):

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Thus, contrary to the bland assertion of taxpayer's counsel (Answering Br. 10), we think the above case is particularly apposite to the present issue.

B. We also think the case of *Knight-Campbell Music Co.* v. *Commissioner,* 155 F. 2d 837 (C.A. 10th), cited on page 22 of brief for Agnes M. Kanne, clearly supports our position on the present issue. That corporation had obtained judgments in its favor for the benefit of a majority of its preferred stockholders against the directors who were common stockholders, and receivers were appointed to operate the business. Pending appeal from the judgments, two of the directors retained attorneys to terminate the receivership and to resist the receivers' application for authority to liquidate the corporation's business. During the hearing on the receivers' application, settlement was reached providing for retirement of the preferred stock and for continuance of the business; the corporation assigned to one of the directors the judgments which were thereupon cancelled. Later the corporation reimbursed the directors for fees which they had paid to their attorneys, and the corporation claimed a deduction in its income tax return for 1942 for the amount of those attorneys' fees. The Commissioner of Internal Revenue disallowed the deduction, the Tax Court sustained the Commissioner, and the Court of Appeals affirmed. The Court of Appeals said (p. 840):

> A liability voluntarily assumed or paid by a corporate taxpayer as reimbursement of two of its stockholders for sums which they paid to attorneys as a fee for services rendered primarily in behalf of certain stockholders in securing cancellation of personal judgments which the taxpayer held against such stockholders is not an ordinary and necessary expense in carrying on

> the trade or business of the taxpayer, within the meaning of section 23, supra.

The above case and those cited on page 22 of the brief for Agnes M. Kanne were cited, of course, to sustain our position that the District Court was correct in its finding that repayment of the $396,812.50 by the taxpayer to its co-defendants was wholly voluntary. (R. 77-78.) Our position in this respect was not based upon any assumption that the taxpayers had agreed that its co-defendants would pay a part of the expenses, as counsel for the taxpayer mistakenly assert. (Answering Br. 16.) Whether or not the taxpayer would be entitled to a deduction for $396,812.50 if it had paid all the expenses in the first instance is not before this Court for decision. We are concerned here with the correctness of the finding of the District Court that the taxpayer in 1932 voluntarily repaid to its co-defendants the above sum which they incurred and paid prior to 1932 as their share of the litigation expense. (R. 77-78.)

For the foregoing reasons and all those discussed in Point II of our main brief, we submit the District Court's judgment in denying the deduction of $396,812.50 in 1932 was correct, and should be affirmed.

II

The situation respecting the $50,000 contribution to the Henry Waterhouse Trust Company is not comparable to a second mortgage transaction. A mortgagor of a second mortgage is in fact a debtor because he has actually borrowed the money secured by the mortgage. At the time he borrows the money from the mortgagee, an appraisal of the fair market value of the property securing the loan presumably discloses

a value high enough not only to discharge the first mortgage but the second one too. The only contingency involved is the inherent risk in all such transactions that subsequent events might so depress the market for the property that the entire amounts of the loans could not be realized upon foreclosure sale of the property. But in the instant case the serious financial predicament (insolvency) of the Henry Waterhouse Trust Company was known when the contributions to the fund to help it meet the emergency were made, and they were made to prevent the disastrous effect its failure would have on the community and without expectation of repayment. (R. 60-61, 96, 102-103.) If the amounts paid into the Henry Waterhouse Trust Company fund were truly loans perhaps the motives which activated these payments might not be determinative of the deductibility thereof. But the motives which induced the taxpayer and the other contributors to make payments into that fund in 1931 certainly may be inquired into to ascertain whether they truly intended to loan the money or merely contribute it without expectation of repayment. As we pointed out in our main brief (pp. 32-33), the finding of the District Court that the taxpayer's payment of $50,000 was merely a contribution without expectation of repayment is supported by the entire record. The taxpayer has failed to point to any evidentiary facts from which this Court may properly conclude that the lower court's finding in this respect was clearly erroneous. So that court's finding must stand.

A. There is, of course, no authority for recognizing a reserve for losses which is set up as the result of a reappraisal of assets as a sufficient basis for the ascertainment of the uncollectibility of an indebted-

ness. The value of assets fluctuates with changing conditions and an accountant's notion of what amount, if any, should be set up as a reserve for *unrealized* losses based on such an appraisal may be good accounting but it does not satisfy the statutory requirements of Section 23(k) of the Internal Revenue Code, which contemplates an ascertainment based on the happening of some event and the occurrence of actual facts then a reality. At any rate, the District Court found as a fact that there was at the end of 1932 a balance of \$190,457.35 remaining in the reserve for losses against which future losses must be charged before there would be any impairment for the repayment of the \$400,000 contributions to the special noteholders. That balance in the reserve was what was left after there had been charged against the reserve actual losses sustained. (R. 95.)

As pointed out at the trial by counsel for Agnes M. Kanne, the bank examiner's report to which taxpayer's counsel refer (Answering Br. 28-29) relates to an examination which was conducted during the year 1933 and is dated July 20, 1933, after the taxpayer had written off the \$50,000 as a bad debt. Although the trial judge refused to strike that report from the record, he said he would keep in mind that this report was made in 1933 after the former transactions of writing off the bad debt. (R. 562-563.) So, it certainly cannot be denied that, as the taxpayer did not have before it in 1932 the bank examiner's report dated July 20, 1933, that report had nothing whatsoever to do with the taxpayer's writing off the \$50,000 as a bad debt in 1932. Accordingly, as taxpayer's counsel have failed to show wherein the facts as found by the District Court (R. 91-96) are clearly erroneous, they must

stand. It follows that the District Court's conclusions of law concerning the non-deductibility of the $50,000 should be affirmed.

Respectfully submitted,

THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
LELAND T. ATHERTON,
Special Assistants to the Attorney General.

RAY J. O'BRIEN,
United States Attorney.

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